MOODY'S ASSIGNS Aa3 RATING TO STATE OF CALIFORNIA GO BONDS

Revises Outlook To Positive

NEW YORK, Feb 22, 2000 -- Moody's has assigned a rating of Aa3 and revised its outlook from stable to positive for the general obligation bonds of the State of California. The rating and positive outlook reflects the state's deep, diverse and growing economy which significantly outpaced the nation over the last two years despite its exposure to the Asian recession, its improved financial condition, including the rebuilding of cash and budget reserves to record levels, improved financial management, and increased attention to debt management issues. These strengths are offset by the state's highly volatile revenue structure and its limited ability to make mid-year budget adjustments in response to unanticipated economic softening. In addition, the state's significant infrastructure needs put pressure on its moderate debt position, although developing debt management policies offer the potential for managing debt issues successfully.

These public education facilities general obligation bonds are being used to retire commercial paper notes which were issued to finance public school (K-12) facilities and costs of program operation. The Aa3 rating is based on the following credit considerations.

STATE ECONOMIC GROWTH PROJECTED TO CONTINUE TO OUTPACE NATION

Over the last three years, the state has enjoyed healthy gains in both employment and personal income, comfortably outpacing the nation as measured by these two economic indicators. Such growth occurred despite the adverse effects of the Asian recession on state exports over the last two years. While the economic weakening of the Pacific Rim contributed to employment declines in high-tech manufacturing in the state, these job losses were more than offset by continued growth in the services (particularly high tech services), construction and tourism industries.

Economic growth in California and the U.S. exceeded consensus forecast estimates for 1999, both in terms of employment and personal income growth. During 1999, the state posted employment gains of 3.3%, 1.5 times that of the U.S. And growth in personal income (6.7%) was the strongest realized by the state since 1988. The state's continued expansion has helped drive the state's unemployment rate below 5% for the first time since 1970. Stubbornly high unemployment rates in the inland regions still keep the statewide unemployment rate higher than the nation's despite tight labor markets in the Bay Area, Orange County and San Diego County.

Through the first three quarters of 1999, California exports have increased by 10.2% over 1998 levels, reflecting - in part - the positive economic growth being generated by the Pacific Rim economies. In addition, taxable retail sales for this same period grew by 9%, reflecting, in inflation-adjusted terms, the most rapid growth in retail sales the state has enjoyed since the early 1980's. The economy's increased diversification has positioned it for further expansion in the near term, and Moody's anticipates the state's economy will continue to outperform the nation over the next two years. And with Asian economies beginning to post positive economic gains, there is upside potential for the state's economic and revenue forecast. Any gains above the marginal economic growth that is forecasted by the state for Asia would undoubtedly have a beneficial impact on state exports, and would lead to increased employment growth for the state beyond current forecasts.

HEALTHY CASH POSITION PROVIDES BUFFER AGAINST REVENUE VOLATILITY

The state ended fiscal 1999 with total borrowable resources of $8.7 billion, including a $1.255 billion balance in its Special Fund for Economic Uncertainties (SFEU). Combined with an ending general fund cash balance of nearly $850 million, the $9.6 billion in available resources is the most the state has had on hand in over two decades. The state is currently projecting that it will end the current fiscal year with $9.1 billion in available resources, after its $1 billion Revenue Anticipation Note repayment. These sizable balances provide a moderate buffer against the state's historic revenue volatility during periods of economic downturns, a product of its economically sensitive tax structure.

The state anticipates it will end the current fiscal year with a General Fund balance of $3 billion, including $2.4 billion in its Special Fund for Economic Uncertainties. Such healthy balances reflect the strong revenue growth realized by the state though the first half of the fiscal year. Based on these gains, the state is now projecting tax revenues will grow by 11% over fiscal 1999 totals, more than 3 percentage points over budget. But in its analysis of the Governor's proposed fiscal 2001 budget, the Legislative Analyst's Office (LAO) has commented that the state's revenue forecast for both the current year and budget year may be too conservative. The LAO points out the governor's revenue forecast was prepared prior to the end of the fiscal year, and thus did not reflect the extremely positive revenue developments of the final two months of 1999. Such developments include dramatic growth in personal income tax withholding, suggesting considerable strength in wages, bonuses, and stock options in late 1999. Based on this and other additional year-end data, the LAO believes the state's revenue collections through fiscal 2001 could exceed the governor's forecast by $3 billion.

PROSPECTS FOR MID-YEAR BUDGET CORRECTION MECHANISM FADE

Governor Gray Davis' inaugural budget submission for fiscal 2000 included a proposal to allow the state Director of Finance to revise the budget if revenue collections fell below budgetary forecasts. But this proposal was rejected by the legislature, reflecting both the state's strong economy and fund balance levels as well as reluctance by the legislature to yield policy authority to the executive branch. The power of the Governor to fine tune agency spending within the year and make reductions should revenues deteriorate is weak in California compared to most states. The California system more closely resembles the federal system in this regard, which led to deeper deficits during the early 1990s than in states that were able to respond more swiftly.

GOVERNOR'S 2001 BUDGET PROPOSES CAUTIOUS REVENUE FORECAST, SUBSTANTIAL ONE-TIME SPENDING ITEMS

On January 10th, the Governor submitted his fiscal 2001 budget proposal to the California Legislature. Continuing the cautious budgeting approach taken last year, the budget conservatively assumes general fund revenues will grow by 4.7% above projected current year totals. The assumed growth rate is significantly less than the healthy revenue growth the state has enjoyed over the last several years, and reflects - among other things - the state's assumption that capital gains tax collections will decline by 5% in 2000 and remain flat in 2001 after having realized gains of 22% in 1999. Consistent with this revenue assumption, general fund expenditures will grow by 4.5% over current year estimates, less than half of rate of growth over the last two years. The Governor's budget proposal contains relatively few new ongoing initiatives outside of its increased investments in education, both in K-12 and higher education. The proposal does include approximately $2.9 billion in one-time spending and set-asides, including $500 million for legal contingencies and $400 million for capital outlays. These non-recurring spending items provide an additional buffer against potential future revenue deterioration. The proposed tempered spending growth (as compared to prior years) would enable the state to maintain a moderate balance in its Special Fund for Economic Uncertainties, representing 1.8% of total general fund expenditures, still small by national standards.

FUTURE CAPITAL NEEDS LIKELY TO INCREASE DEBT BURDEN, HIGHLIGHTING ROLE OF MULTI-YEAR CAPITAL PLANNING PROCESS

The state's economic and financial improvement over the last several years, and the moderation of debt issuance for prison construction, have led to an improvement in its debt ratios. While they are still above the national medians, the difference between the state's ratios and the national medians has narrowed. As reflected in our recently released 2000 Debt Medians Report, California's net tax-supported debt per capita and debt as a percentage of personal income rank 19th and 22nd, respectively.

Currently, debt service represents approximately 4.2% of state general fund revenues. The state treasurer's June 1999 report illustrates that if revenues and expenditures annually grow in tandem at a rate of 5.5% over the next ten years, the state could assume an additional $32.5 billion in debt during this period without exceeding the 4.2% targeted ratio. However, as pointed out in the report, the state's long-term debt capacity is strongly affected by general fund revenue volatility. If revenue growth is one percentage point less than the projected 5.5%, then the state's debt capacity for the ten-year period decreases to approximately $5 billion. The potential for such swings in debt capacity and the scale of capital needs facing the state highlight the need for the state to adopt a multi-year capital planning process. Such a formal process would enable the state to adequately address its long-term infrastructure needs without limiting budgetary flexibility, especially during periods of weakening economic and revenue performance.

OUTLOOK:

The rating outlook for the state is positive. Emerging changes in the approach to debt and budget management offer the potential for the state to position itself to weather cycles more successfully, despite its volatile revenue structure and inflexible spending base. These include cautious revenue forecasts, which avoid committing the most volatile part of the revenue base to fixed expenses, improved reserve levels, and efforts to deploy revenue windfalls to one-time investments that improve the state's readiness for future revenue stress. In the near to medium term, the economy is projected to continue to grow, and should continue to outpace the nation but at a more moderate rate than that of the last two years. Any rebound of the Asian economies beyond the marginal growth currently anticipated by the state will have a beneficial affect on job growth, particularly in the high tech manufacturing sector. And given the scale of capital needs, the debt burden is likely to grow, further highlighting the importance of new plans to institute a formal multi-year capital planning process.

DEBT AFFECTED:

ISSUE		RATING
Public Education Facilities Bonds, Series H		Aa3
Sale Amount	$500,000,000	
Expected Sale Date	02/23/00	
Rating Description	General Obligation Bonds	

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